

**WRITTEN STATEMENT**

**of**

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**And**

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**Before the  
Committee on Energy and Commerce Subcommittee  
on Oversight and Investigations  
United States House of Representatives**

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## **Executive Summary of the Statement of Jane Mago and Carol Matthey**

Over the course of the first six years, the E-rate program has committed over \$11 billion in funds to schools and libraries throughout the nation. According to the U.S. Department of Education, while only fifty-one percent were connected in 1998, the program's first year, ninety-two percent of classrooms in public schools were connected to the Internet in 2002. Ninety-nine percent of public schools now have Internet access, and ninety-four percent of them have broadband connections. By connecting these schools we help to ensure that future generations have the skills they need to achieve their dreams in a digital era.

While pleased with the positive results achieved by the E-rate program, the Commission remains committed to eradicating occurrences of waste, fraud and abuse. The Commission's oversight program has had three chief components – rulemaking, fact-specific adjudicatory decisions, and auditing. In 2002 the Commission began an ongoing review process to improve the E-rate program. Since then, the Commission has issued a series of orders that have made the program's requirements more transparent for all and eliminated loopholes brought to our attention in the program's first years. The comment cycle on the most recent Further Notice of Proposed Rulemaking closed in April, and we expect to release several further Orders beginning later this quarter. We also are using the rulemaking process to address certain aspects of program design raised by the Office of Inspector General. For instance, the Wireline Competition Bureau has recommended that the Commission refine its rules for recovery of funds committed in violation of statutory or FCC requirements, and strengthen its document retention requirements to enhance our oversight activities, as recommended by the FCC's Office of Inspector General.

Today's hearing is focusing on the special case of the E-rate applications of the Puerto Rico Department of Education (PRDOE). Since 2000, when PRDOE was included in a randomly selected audit of seventeen program beneficiaries, the Commission has worked to understand and determine how to handle the situation in PR. As detailed in the written statement, the PR story is a complex one that touches on multiple parties including officials from PRDOE, USAC, the FBI, DOJ, DOE, the FCC and the FCC's OIG as well as service providers. At the core of the PR story is the new PRDOE administration admitting to USAC and to Commission staff in 2002 that things were amiss under the prior administration in the expenditure of E-rate funds. The new PRDOE administration said that it would take corrective action, including making major personnel and structural changes to mitigate and correct the problems of the prior administration. Early in 2003, the new PRDOE administration requested in writing that the Commission direct USAC to process its applications and disburse funds for program years 2001 and 2002. This letter commenced the adjudicatory process, and Commission staff sought public comment on that request, received filings from three parties, and prepared recommendations for the Commission.

On November 25, 2003 the Commission issued the *PRDOE Order*, concluding that it would be appropriate for USAC to resume processing of PRDOE's pending applications for funding years 2001 and 2002 upon completion of a targeted, independent audit designed to provide assurances of PRDOE's compliance with the FCC's rules. The Commission maintained USAC's suspension of PRDOE's first three years of participation in the program, pending completion of a separate independent audit and further action by the Commission.

The Order set forth a trust but verify policy applicable beyond PR and held that USAC generally should defer action on any application upon receiving evidence, including evidence from an active law enforcement investigation, of potential program violations, until such time as questions raised by the evidence can be resolved, or until there is sufficient reason to believe that potential program violations are no longer implicated. The targeted audits called for in the FCC's

November order have begun. We hope that PRDOE can demonstrate that it was in compliance with our rules when it submitted its applications in 2001 and 2002. Meanwhile, we are reviewing our rules and audit procedures to learn from this experience.

As the PRDOE situation illustrates, we also oversee the operation of E-rate through a system of audits that is a measure of day-to-day compliance with our rules. We are committed to expanding that system. In 2003, audits were finalized for 106 randomly selected beneficiaries, with the work performed by USAC's audit staff, USAC's outside auditor, and the FCC's Office of Inspector General. Collectively, those audits covered \$263 million in disbursements and the audit findings required only \$3 million in recoveries. That is: *professional auditors found an error rate of less than 1.2 percent* in the audits completed last year. In 2004, the Commission is implementing an even more intensive audit program. The agency is taking steps to ensure that our Inspector General has the resources to undertake an expanded audit program. We intend to use statistical sampling techniques, so that the audit results can provide a basis for forming conclusions about overall program compliance. We also are supportive of USAC's plans to step up its outreach efforts to better educate beneficiaries by scheduling 1,000 site visits a year.

We remain committed to making ongoing improvements in the e-rate program and to resolving outstanding issues surrounding PR. We look forward to your questions on these issues. Thank you, Mr. Chairman, for the opportunity to participate in your review of the universal service fund's schools and libraries support mechanism and the E-Rate program in PR.

## **STATEMENT OF JANE MAGO AND CAROL MATTEY**

Good morning, Chairman Greenwood, Representative Deutsch, and distinguished members of the Subcommittee. We appreciate the opportunity to appear before you to discuss the FCC's efforts to continue to improve the E-rate program and provide critical support enabling schools and libraries to access the vast resources of the Internet. The Commission is proud to be implementing this important aspect of universal service support.

### Introduction

The schools and libraries mechanism of the FCC's universal service program, often called the E-rate program, has provided discounts enabling literally millions of school children and library patrons, including those in many of the nation's poorest and most isolated communities, to obtain access to modern telecommunications and information services for educational purposes. Our nation has benefited significantly from the E-rate program, which the FCC created to fulfill Congress's direction in section 254(h) of the Communications Act.

Over the course of the first six years of its existence, the E-rate program has committed over \$11 billion in funds to schools and libraries in every state in the nation. This support has benefited communities across the country, large and small, urban and rural. According to the U.S. Department of Education, ninety-two percent of classrooms in public schools were connected to the Internet in 2002, while only fifty-one percent were connected in 1998, the first year of the program. Ninety-nine percent of public schools now have Internet access, and ninety-four percent of them have broadband connections.

This tremendous progress is due in significant part to the discounts available from the E-rate program.

As an ongoing matter, the E-rate program enables schools and libraries to pay discounted rates to keep this access affordable. Once the schools and libraries are wired, they still face monthly recurring service charges for telecommunications service and Internet access. These service charges are sizeable. Indeed, in the 2004 filing window schools and libraries sought support for \$1.6 billion in telecommunications services and Internet access.

The Universal Service Administrative Company (USAC) administers the E-rate program on a day-to-day basis. USAC is a public non-profit company that administers all four universal service programs. Among other things, USAC currently processes nearly 40,000 E-rate applications a year and disburses funds for approved applications. USAC operates within the rules established by the FCC for the E-rate and other universal service programs, and the Commission and its staff exercise oversight over USAC.

As the E-rate program approaches its seventh birthday, the Commission is actively assessing where we are and how we can improve the E-rate program going forward. This is very much a team effort within the FCC, with regular interactions between the Wireline Competition Bureau, the Enforcement Bureau, the Office of Managing Director, the Office of General Counsel, the Office of Strategic Planning and Policy Analysis, and the Office of Inspector General.

Despite the existence of bad actors that have taken advantage of certain aspects of the program design, we believe that this program has been an overall success. There will always be those who try to game the system, but the Commission is committed to closing

the avenues where abuse can occur and eradicating all waste, fraud and abuse in the E-rate program. We recognize that it is our job, as it has been from day one, to maintain oversight over the E-rate program. And while there have been aberrations, by and large, we have enabled implementation of the statutory goals with a minimum of waste, fraud and abuse.

- The Commission's oversight program has had three chief components – rulemaking, fact-specific adjudicatory decisions, and auditing – and these three components continue to reinforce each other as the program enters its seventh year.
- We will be expanding the scope of our auditing work in the coming year substantially, in order to meet our obligations under the Improper Payments Information Act of 2002 (IPIA). Although the audit work conducted to date suggests that the level of rule noncompliance is relatively low, our goal is eradication. Let us emphasize: waste, fraud and abuse is never acceptable. We will work vigorously to protect these dollars from misuse.
- Finally, the systems we have in place have successfully detected situations, like the Puerto Rico Department of Education, where program participants have run afoul of our rules. We learn from our experiences: corrective measures have been launched to rectify past problems, and prevent them from recurring in the future. And through these efforts, we seek to ensure that the school children and library patrons across America continue to enjoy the benefits of affordable access to advanced telecommunications and information services.

### Oversight Through Rulemakings

In 2002, the E-rate program's fifth year, the Commission began an ongoing review process, which continues to this day, to consider ways to improve the E-rate program. The Commission issued a Notice of Proposed Rulemaking (NPRM) to seek comment on ways to ensure that E-rate program funds are utilized in an efficient, effective, and fair manner, while preventing waste, fraud and abuse. Since then, the Commission has issued a series of orders that have brought us further down the road to improve the E-rate program, and the Commission continues to pursue these reform goals today. Through our rulemaking process, we seek to make the Commission's requirements more transparent for all and to eliminate confusion as to what the FCC expects of participants in this program.

In the last year, the Commission's rulemaking activities have focused on tightening our rules to prevent waste of the limited E-rate dollars by bad actors who seek to take advantage of certain aspects of the program's design. For example, in April 2003, the Commission adopted rules to debar individuals and companies that have proved to be bad actors. We have procedures to expel from the program anyone convicted of a criminal violation or found civilly liable for actions relating to this program. We already have applied these procedures to several companies, and we have sought comment on what other situations may warrant debarment.

In December 2003, the Commission emphasized that our rules have always prohibited funding of duplicative equipment and service. The Commission also adopted new rules limiting the transfer of E-rate funded equipment and limiting repeated requests for internal connections. The Commission clarified the types of maintenance services that

are eligible for support, and adopted a more transparent process for updating the list of eligible services in future years. In addition, the Commission directed USAC to develop a pilot program to test a computerized online list of eligible internal connections equipment, a measure expected to enable USAC and the Commission to better track the types of equipment the program is supporting.

The Commission's rulemaking efforts to improve the E-rate program are ongoing. In December 2003, the Commission requested comment on additional proposals designed to curb the occurrence of waste, fraud and abuse. For instance, the Commission asked for public comment on whether to adopt bright line rules for determining "cost effective" funding requests, such as a specified dollar amount per student or library patron for specific types of service; whether to codify additional requirements for technology plans; and whether to require that beneficiaries disclose their use of outside consultants. The Commission also sought comment on whether to lower the highest discount rates, in response to suggestions that the current discount levels may not provide sufficient incentives to make prudent funding requests. The comment cycle on this Further Notice of Proposed Rulemaking closed in April, and we expect to make further recommendations in two or more orders, one to be presented this quarter and the other to be presented next quarter.

We also are using the rulemaking process to address issues of program design raised by the Office of Inspector General. For instance, the Wireline Competition Bureau is recommending that the Commission refine its rules for recovery of funds committed in violation of statutory or FCC requirements, and strengthen its document retention requirements to enhance our oversight activities, as recommended by the FCC's Office of

Inspector General. We believe that such measures, if adopted, would greatly reduce the occurrence of waste, fraud and abuse by those who seek to unjustly enrich their own fortunes to the detriment of the E-rate program.

In addition, we are working to synchronize our rules and USAC's procedures. USAC has established numerous operating procedures to administer the e-rate program on a day-to-day basis. USAC needs the flexibility to act swiftly in response to specific inquiries and situations. The Commission has codified a number of USAC procedures through the rulemaking process in the last year, and the Wireline Competition Bureau has directed USAC to prepare a list of all USAC procedures a violation of which should form the basis for recovery of funds. We are working to establish "bright lines" for beneficiary compliance, where possible, and to make clear to beneficiaries the consequences of noncompliance.

To sum up, as the program has matured, the measures taken by the Commission to improve the E-rate program through our rulemaking oversight have evolved beyond tightening "nuts and bolts," to refining the application and disbursement processes, to addressing broader policy issues, such as creating incentives for beneficiaries to reduce waste and promote more equitable consumption of the program's resources.

#### Oversight Through Adjudications

The second oversight tool the Commission uses is adjudication, deciding specific factual cases under our rules.

Section 54.702(c) of the Commission's rules expressly states that USAC "may not make policy, interpret unclear provisions of the statute or rules, or interpret the intent of Congress. Where the Act or the Commission's rules are unclear, or do not address a

particular situation, the Administrator shall seek guidance from the Commission.” Our rules also expressly provide that any party may seek Commission review of any action taken by USAC. Through our review of appeals of specific decisions made on E-rate applications, as well as our examination of broader questions that necessarily arise in the course of administering a \$2.25 billion per year funding program, we exercise oversight over the universal service fund and implement measures to reduce the occurrence of waste, fraud and abuse.

By 2003, the Commission was aware that there were a number of cases in which either a service provider, a beneficiary, or both, were under some form of investigation that implicated their involvement in the E-rate program. The Commission concluded that it was imperative to address some specific problem situations. In doing so, it developed a general framework for how to protect the E-rate fund in situations in which one or more parties is under investigation for potential waste, fraud and abuse, while remaining sensitive to the interests of parties that ultimately may be cleared of any wrongdoing.

The Commission stated and applied its general framework in the *Puerto Rico Department of Education (PRDOE) Order* issued in November 2003. The Commission unanimously held that USAC generally should defer action on any application upon receiving evidence, including evidence from an active law enforcement investigation, of potential program violations, until such time as questions raised by the evidence can be resolved, or until there is sufficient reason to believe that potential program violations are no longer implicated. The Commission expressly recognized that it may be appropriate to fund applications, notwithstanding the pendency of an ongoing law enforcement investigation, after subjecting such applications to an especially probing and cautious

review. This minimizes inadvertent harm to innocent parties, such as a school and its students, or a library and its patrons, who may have no involvement in any of the alleged wrongdoing.

Today's hearing is focusing on the special case of the E-rate applications of the Puerto Rico Department of Education (PRDOE). We are pleased to work with the subcommittee and its staff in looking at these transactions. PRDOE, in fact, is a case-in-point of how the Commission's sequential process of rulemaking, adjudication, and audit is effective.

In 2000, PRDOE was included in a randomly selected audit of seventeen program beneficiaries conducted for the first program year performed by outside auditors engaged by USAC, and field work commenced later that year. In April 2001, the Office of the Comptroller General of Puerto Rico informed the FCC's Office of Inspector General that the Comptroller had found evidence that PRDOE had not complied with state and local procurement regulations during years one and two of the schools and libraries program. The IG referred the matter to the Federal Bureau of Investigations in May 2001. Meanwhile, USAC concluded its audit process in October 2001 and, in December 2001, issued a letter to PRDOE suspending all pending disbursements and placing further application processing on hold, pending receipt of further information.

Over the course of 2002, PRDOE provided additional information to USAC and Commission staff. The new PRDOE administration admitted to USAC and to Commission staff that things were amiss under the prior administration in the expenditure of E-rate funds. The new PRDOE administration said that it would take corrective action, including making major personnel and structural changes to mitigate and correct

the problems of the prior administration. In numerous meetings and discussions FCC staff and PRDOE officials focused on ways to permit PRDOE to participate in the E-rate program, while ensuring appropriate protections against waste, fraud and abuse. In addition, over this time, FCC staff coordinated with officials at the Department of Education and Department of Justice regarding investigations relating to PRDOE and proposals to ensure appropriate handling of funds in the future.

Ultimately, and in recognition that the need to revalidate the eligibility of E-rate applicants might not be unique to PRDOE, Commission staff concluded that a public comment process would provide the best way for the agency to move forward. While admittedly more time consuming than what the parties had hoped, this process was transparent and fair. Early in 2003, the new PRDOE administration requested in writing that the Commission direct USAC to process its applications and disburse funds for program years 2001 and 2002. This commenced the adjudicatory process, and Commission staff sought public comment on that request, received filings from three parties, and prepared recommendations for the Commission.

On November 25, 2003 the Commission issued the *PRDOE Order*, concluding that it would be appropriate for USAC to resume processing of PRDOE's pending applications for funding years 2001 and 2002 upon completion of a targeted, independent audit designed to provide assurances of PRDOE's compliance with the FCC's rules. The Commission maintained USAC's suspension of PRDOE's first three years of participation in the program, pending completion of a separate independent audit and further action by the Commission.

In concise terms, the *PRDOE Order* lays out a “trust but verify” policy towards the current Puerto Rican situation. The Commission’s trust is based on the current Puerto Rican administration’s assertion that it has complied with the Commission’s rules and has implemented a plan to correct fundamental deficiencies in the infrastructure of PRDOE’s schools and offices. The required audits are the means by which the Commission verifies the assertions of the new PRDOE administration.

The PRDOE experience provides a good lesson on how the FCC can enhance program integrity through routine detection, intervention and responsive policymaking. Irregularities with PRDOE were uncovered through routine program audits and self-disclosure by a subsequent administration. USAC responded with the measured response that demanded resolution of program violations before risking further E-rate dollars. The Commission used its review of PRDOE to craft a general policy framework to deal with entities subject to investigation for failure to comply with our rules. This newly enunciated policy allows PRDOE to move forward as a program participant if it can pass the rigors of a targeted audit designed to test the areas that routine audits identified as weaknesses under the prior administration.

The Puerto Rico story is not over. The targeted audits called for in the FCC’s November order have begun. We hope that PRDOE can demonstrate that it was in compliance with our rules when it submitted its applications in 2001 and 2002. Meanwhile, we are reviewing our rules and audit procedures to learn from this experience. We all come away wiser, and the E-rate program will be stronger as a result of this experience. The lessons we have learned here and the process we have in place

hopefully will make the E-rate program work better in the future. We are hard at work to avoid a “next time.”

Even while devoting significant staff resources to addressing the PRDOE case, the Commission ruled in two other major E-rate adjudications in 2003. The Commission issued a major order that closely examined procurement practices in a number of school districts, not in Puerto Rico, that collectively sought over \$250 million in E-rate funding. The Commission concluded that those practices thwarted the Commission’s competitive bidding requirements and clarified what applicants need to do to comply with our rules. Also in 2003, the Commission addressed a case where a key individual associated with a service provider that provided state-wide internet access service was under law enforcement investigation. In that case, the Commission concluded it was appropriate not to provide any support to that service provider pending resolution of the investigation. At the same time, the Commission made provisions to ensure that subcontractors that were not in any way implicated by the investigation would receive payments for services rendered. We note as well that the Commission decided each of these adjudications unanimously.

#### Oversight Through Audits

As the PRDOE situation illustrates, we oversee the operation of E-rate through a system of audits that is a measure of day-to-day compliance with our rules. We are expanding that system, to ensure that we detect the bad actors we know will try to take advantage of the program.

The Commission is strongly committed to maintaining a robust audit program for the E-rate, and is working closely with USAC on all audits. Audits of the E-rate program

provide important information to the Commission in assessing program compliance, and also in helping the Commission identify steps that it may take to help reduce the likelihood of waste, fraud and abuse.

We have an active E-rate audit program. Since the E-rate program's inception, USAC has conducted beneficiary audits. USAC now has twelve full-time staff that conducts internal audits of the program, and also engages external independent auditors to do more extensive audit work. The Wireline Competition Bureau has two full-time audit staff dedicated to universal service oversight, as well as two audit staff that perform that function on a part time basis.

In addition, our Office of Inspector General dedicates three of its eight auditors to Universal Service Fund oversight. In October 2001, we detailed another four auditors from the Wireline Competition Bureau (then known as the Common Carrier Bureau) to assist in auditing the E-rate program. In January 2003, we entered into a Memorandum of Understanding with the Department of Interior and USAC to conduct additional E-rate audits. Two audits have been completed under this arrangement and fieldwork has been completed in three more.

The audit program is a cooperative effort. In December 2002, for example, USAC engaged in an independent auditor to conduct 79 beneficiary audits from funding year 2000. At our request, these audits were conducted according to government approved standards so that our Inspector General could more easily use the data from those audits for our purposes.

Early audits of the E-rate program were directed at a discrete number of high dollar beneficiaries. More recently, the audit program has expanded in terms of sheer

numbers of beneficiaries audited and the random selection of such beneficiaries. The annual number of audits has grown from about two dozen in the early years to over one hundred in 2003. These audits are conducted by professional auditors, both internal USAC audit staff, and independent auditors with whom USAC contracts. To date, audits have been conducted of beneficiaries that collectively have received over \$1.1 billion in disbursements.

In 2003, audits were finalized for 106 randomly selected beneficiaries, with the work performed by USAC's audit staff, USAC's outside auditor, and the FCC's Office of Inspector General. Collectively, those audits covered \$263 million in disbursements and the audit findings required only \$3 million in recoveries. That is: professional auditors found an error rate of less than 1.2 percent in the audits completed last year. We want to lower that already low percentage, but this recent work provides some comfort that waste, fraud and abuse is not endemic to the program and that improvement should continue.

In 2004, the Commission is implementing an even more intensive audit program. We intend to use statistical sampling techniques, so that the audit results can provide a basis for forming conclusions about overall program compliance and provide needed information so that we can comply with the IPIA. These efforts will provide the Commission with more and better information on program and participant performance.

Funding this expanded audit program has been challenging. Last year, for example, the FCC unsuccessfully sought an appropriation to enable our Inspector General to conduct independent audits of the Universal Service Program. In the interim, we have drafted a new three-way agreement among the FCC, the FCC's Inspector General, and

USAC to enable us to move forward with necessary audits. Under this agreement, USAC will contract with independent auditors, applying government auditing standards to conduct audits of a statistically significant number of E-rate recipients. We anticipate that the results from these audits will enable us to gauge vulnerabilities in the program so that we can act to correct them.

Finally, we are committed to seeking a legislative clarification of the Commission's authority to permit the FCC to transfer funds from the Universal Service Fund to pay for necessary audits, implementation and recovery actions. This will enable the FCC to contract directly with auditors. We are working with OMB to propose specific legislation to authorize the transfer.

In sum, audits are critical to the oversight package. Audits confirm and close the loop. They provide us with information to assess the wisdom of our rules. They inform future rulemakings; many of the rule changes made in the last year or currently under consideration have been sparked by what the audits have revealed to be weaknesses in the current program design.

And finally, audits are the vehicle by which we determine if monies need to be recovered from particular beneficiaries, so that the benefits of the E-rate program go only to those who comply with our rules. The agency is working to ensure timely resolution of all audit findings, whether those audits are conducted by USAC internal audit staff, independent outside auditors hired by USAC, or the FCC's Office of Inspector General. We are also working to ensure timely recovery of erroneously disbursed funds identified by these audits. We agree that we all need to do better in this area, so that audit and recovery work is completed more expeditiously. We expect that this quarter,

the Commission will act on several recommendations related to these issues made by the Wireline Competition Bureau. We also are supportive of USAC's plans to step up its outreach efforts to better educate beneficiaries by scheduling 1,000 site visits a year.

#### Conclusion

We are committed to making ongoing improvements in the e-rate program, and we look forward to your questions on these issues. We would be happy to provide any assistance to the Subcommittee and stand ready to offer our technical and subject area expertise as you move forward. Thank you, Mr. Chairman, for the opportunity to participate in your review of the universal service fund's schools and libraries support mechanism.